# NATIONAL FORECAST DESCRIPTION

## The Forecast Period is the Third Quarter of 2002 through the Fourth Quarter of 2005

If awards were given out for outstanding service to the U.S. economy, three sectors would have received gold stars. They are light vehicle sales, housing, and federal government spending. Together these three sectors contributed to the mildness of the recession and have kept the economy from slipping into another one. Given their importance, it is worthwhile to review how these sectors are expected to perform in the future.

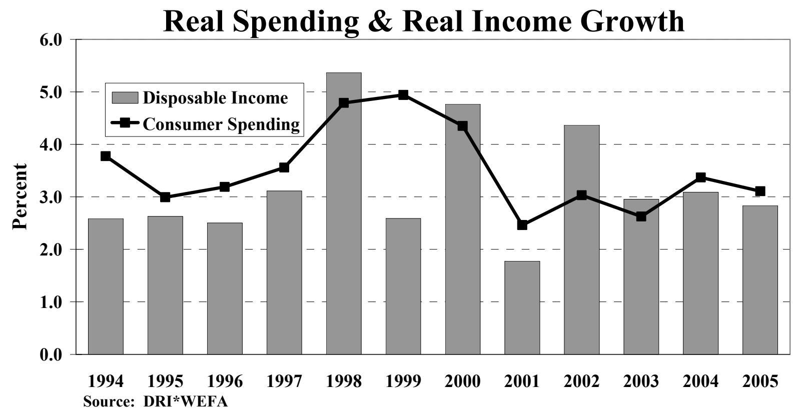
History will record consumers as the heroes of this recession. Unlike in recessions past, Americans kept spending, and this kept the economy from tanking. Of course, they did get some help. Most notably Detroit offered generous financing on vehicles and consumers rushed into showrooms. But this begs the question whether this level of spending can be sustained. It appears not. Consumers rarely retrench, but when jobs are scarce and debts are high, as they are now, the rate of spending slows. Debt-service payments are claiming a record share of disposable income despite the drop in interest rates. As a result, consumer spending should become more income constrained. This means spending should grow at about the same pace as disposable income. Fortunately, incomes are expected to rise faster than prices, so consumers should continue to support the recovery.

Unfortunately, the housing sector is starting to show signs of weakness after going beyond the call of duty earlier this year. Starts are slipping, as are sales of existing homes. Mortgage refinancing continues its red-hot pace, but evidence suggests lenders are becoming more wary of cash-out financing. It also appears lenders are tightening their standards for borrowers. In addition, it appears mortgage interest rates may have hit bottom and will be rising in the near future. Rising interest rates, along with the uncertain job picture and weak financial markets, present a less-than-ideal culture for future housing expansion. Indeed, U.S. housing starts are expected to decline in 2003, but from a very high level. It is also expected to recover in 2004.

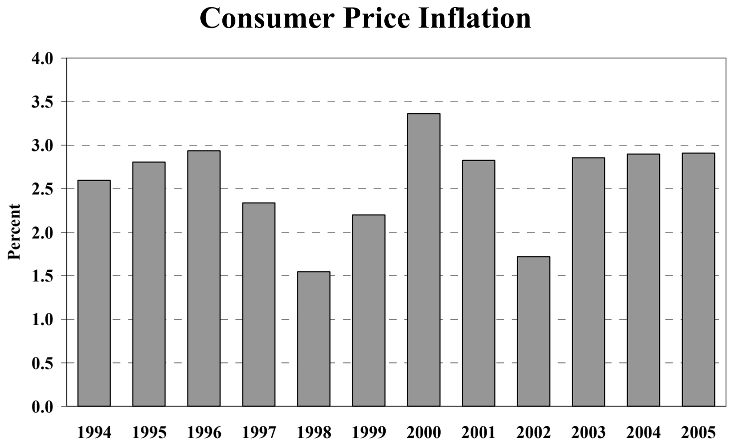
The federal government has done its share by spending at an accelerated pace. Through most of the second half of the 1990s, real federal government spending actually declined annually. However, spending is forecast to ramp up in response to the terrorist attacks. Specifically, real federal government spending should be up 7.6% in 2002 and 5.7% in 2003. One of the questions tied to federal government spending is what would be the economic impacts of a war with Iraq. Interestingly, the most severe impact is likely from the uncertainty of whether the U.S. goes to war. In fact, the economy is already feeling these impacts. For example, current oil prices already reflect a \$3-\$5 per barrel "war premium." The irony is the uncertainty and attendant market jitters will dissipate as soon as the war begins. This was the pattern during the Gulf War and the war in Afghanistan. Much like the earlier conflicts, as soon as the United States makes a decisive move, oil prices are likely to fall, and both confidence and stock prices are likely to rise.

The economy is not expected to slip into another recession in the near future. Although the slow growth has been disappointing, it has been growth nonetheless. The economy should continue moving forward over the forecast period, with real GDP advancing 2.4% in 2002, 3.0% in 2003, 4.0% in 2004, and 3.3% in 2005.

## SELECTED NATIONAL ECONOMIC INDICATORS



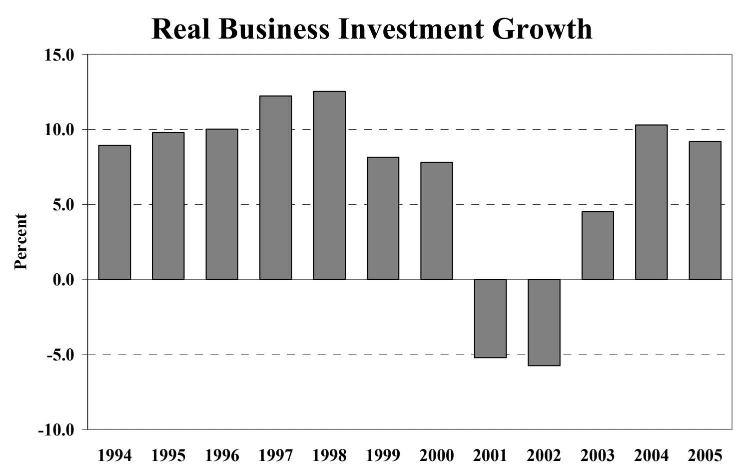

**Consumer Spending:** Despite a soft second quarter, real consumer spending is expected to post a relatively strong showing this year. Spending growth is projected to have heated up to a 4.1% annual rate in the third quarter of 2002 thanks to the predicted 41.1% annual growth of motor vehicles and parts. This sector appears well on its way to reaching that level. Fueled by the return of 0% financing and rebates, light vehicle sales soared to annualized rates of 18.1 million in July 2002 and 18.7 million units in August 2002. Of course, this level of sales cannot continue indefinitely. Given the market is approaching saturation, sales are expected to fall back to the 16.0-16.5 million-unit range over the next two quarters. This should weigh down total consumer spending in the third quarter, but not enough to cause a double-dip recession. Vehicle sales are expected to improve later in the forecast period as the introduction of new models once again lures consumers into dealers' showrooms. Specifically, the sales of cars and light trucks are projected to rise from 16.8 million units this year to 17.0 million units next year, then to 17.6 million units in 2004, and 17.5 million units in 2005. Over the next five years, real consumer spending growth should average 3.0% per year. This slower growth results from the sluggish recoveries in employment and household's need to rebuild savings after the stock market correction. Since the outlook for labor is detailed elsewhere in this publication, it will not be repeated here. Instead, we will focus on the need to rebuild household savings. The stock market implosion erased an estimated $1 trillion in household equity valuation during this year's third quarter, resulting in an estimated $820 billion decline in household net worth. Since peaking in early 2000, the value of household equity holdings have fallen $5.3 trillion, while net worth has diminished $2.9 trillion. The decline in net household income should have a major impact on spending. It has been estimated that households spend about 2.0% of their new wealth. Thus, the decline in net household worth translates into approximately a $60 billion drop in spending, which is less than 1% of this year's total spending. However, the decline in net worth may have another, subtler, impact. During the last few years, Americans spent more of their income. Rising home values and the soaring stock market was doing the saving for them. Given the declines in the stock market, households will have to make more of an effort to save. As a result, the U.S. savings rate is expected to rise from 3.8% this year to 4.3% next year. Once consumers are comfortable the recovery is under way, they should become less thrifty, and the savings rate should slip to 3.9% in 2005. It has also been speculated that the recent rash of home refinancing would provide an infusion of funding for consumer spending. However, this does not appear to be happening. Instead, consumers are using refinancing to rebuild their net worth. This September the mortgage rate on a 30-year loan dropped below 6.0%. If consumers wanted to fund more spending, we would expect them to reduce their monthly payments by refinancing loans at the lower rate and spending the difference. Instead, a rising share of consumers is actually raising their monthly payments by taking out 15-year mortgages in order to improve their net worth faster.



Source: DRI*WEFA

**Inflation:** The inflation outlook remains benign, with few potential pressure points. Import and agricultural prices are the only current threats to this outlook: Important prices because of the soft dollar and crop prices because of concerns over the dry conditions this summer. Still, recent moves in both areas need to be put into perspective—prices for both are still below what they were last year. Outside of these two pockets of concern, there is little to worry about. Input costs down the supply chains have been stirring in recent months, which is characteristic of the early stages of a recovery. The producer price index for crude materials is up more than 11% since the beginning of this year. However, like imports and farm prices, it too is lower than it was a year ago. Moreover, there is no evidence that the commodity price increases have moved into finished goods prices. This, too, is common during the early stages of a recovery. Service cost inflation, as measured by the consumer price index for services, has been growing about 3.0% on a year-over-year rate since January 2002. This is down from the 4.0% rate in 2001 and reflects a combination of factors. These factors include fractionally lower labor cost escalation, strong competition in telecommunication services, and softer rental markets. Taken together, the comparatively mild rebound in goods prices next year and lower services cost increases produce a fairly subdued inflation forecast. Specifically, the consumer price index is projected to rise 1.7% in 2002, 2.9% in 2003, 2.9% in 2004, and 2.9% in 2005.

**Business Investment:** The slide in real business investment is expected to halt by the end of this year, but significant growth is not anticipated until the second half of 2003. As a result, real business investment is expected to shrink over 5.0% for the second straight year in 2002. It is forecast to expand 4.5% in 2003, but at this pace it will not make up the ground lost during the previous two years. Real business investment growth should accelerate over time. In 2004, it is projected to advance a healthy 10.3%. The stronger investment in 2004 versus 2003 is due largely to the expected performance of real nonresidential construction. Specifically, real investment in building is expected to slip 4.8% in 2003 and rise 6.8% in 2004. If there is a silver lining to the 2003 investment decline, it is that the 4.8% drop is major improvement compared to the expected 15.3% drop in 2002. Recent data show just how bad nonresidential construction has been in 2002. It dropped at an annual rate of 17.7% in the second quarter of this year and 8.2% in the third quarter. Data from the U.S. Census Bureau show nonresidential construction has been sliding for 17 months as of August 2002. For a number of reasons, nonresidential construction is not expected to rebound until several quarters after the national outlook improves. First, it takes several months to initiate new construction projects. Second, office vacancy rates are high in most cities, and too many hotel rooms are empty because of previous overbuilding. Third, the soft global economic outlook (and resulting glut of capacity) will delay the rebound in manufacturing construction.



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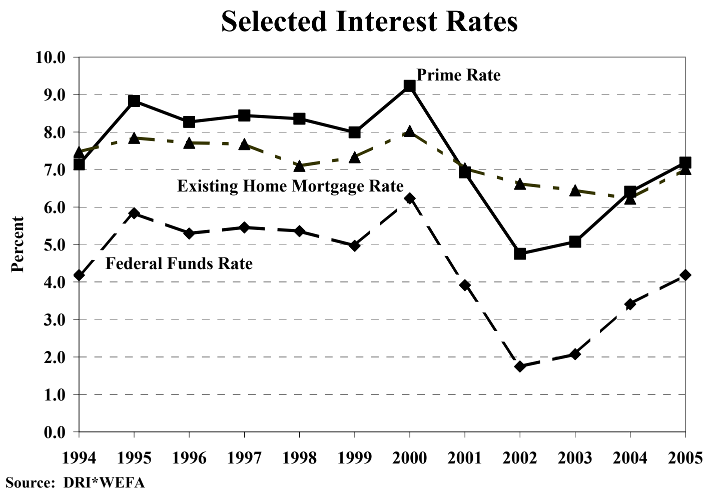
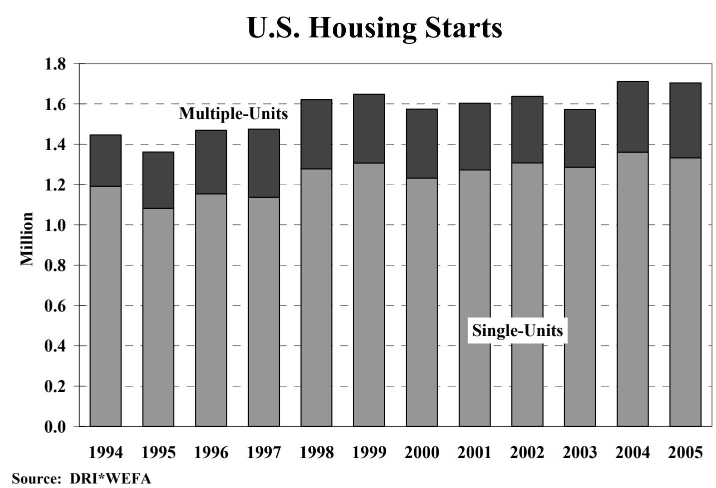


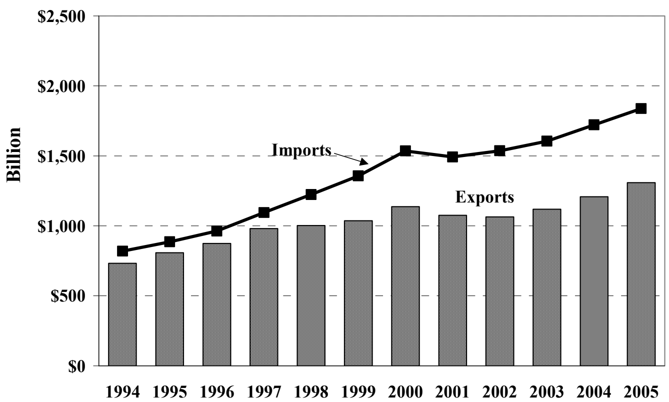

**Financial:** The Federal Reserve's Federal Open Market Committee is not expected to change its bellwether federal funds rate until the second half of next year. In midsummer, some investors and stock analysis felt the Federal Reserve should rescue the market with lower interest rates, and even built lower rates into their forecasts. The Federal Reserve acknowledged financial market problems and its impacts on aggregate demand in its August 13, 2002 press release. However, it believed increased productivity would foster overall economic growth without lowering the federal funds rate. The Federal Reserve decided not to change its federal funds rate during its September 24, 2002 meeting. Once again, the Federal Reserve believed rising productivity would lift the economy out its doldrums. However, the Federal Reserve also hinted the recovery was proceeding moderately and pointed out threats to its continued growth. Interestingly, financial markets were not mentioned in this statement. What is clear in both statements is the Federal Reserve's top priority remains price stability and sustainable growth. This goal and the anticipated short-term performance of the economy shape the financial policies assumed in this forecast. While the recovery has been disappointing, the economy has nonetheless been moving forward, as is expected to continue doing so. As a result, the Federal Reserve will have little incentive to lower rates. In fact, the central bank's next move will be to raise rates beginning in the second half of 2003, when the recovery is on solid footing and the Federal Reserve again focuses on keeping the economy from overheating. It is expected to raise the federal fund rate gradually, so by the end of 2005 it should be at 4.5%. While this is more than twice as high as the current rate, it is 200 basis points lower than the 6.5% rate at the end of 2000.

**Housing:** One of the pillars of the economic recovery, the housing sector, recently developed cracks. The U.S. housing market defied textbook logic during the recovery. Traditionally, consumers are hesitant to take on mortgages soon after an economic calamity, so housing is usually one of the last sectors to recover. However, the U.S. housing sector posted impressive gains in 2001 and 2002. For example, sales of existing and new homes combined rose 4.9% in July 2002. This occurred despite falling consumer confidence, a soft labor market, and slow wage growth. There are several reasons why the housing sector has fared so well. Most obvious has been the decline in mortgage interest rates to record lows boosted the affordability of buying a home. Home ownership was also facilitated by banks that had loosened their borrowing requirements. Soaring prices in some locales made housing a desirable investment, especially compared to the declining stock market. Higher prices also forced many "fence sitters" to purchase a home before they were priced out of the market. As a result of these factors, U.S. housing starts rose to 1.60 million units in 2001 and are expected to rise to 1.64 million units this year. While 2002 shows a slight gain over 2001, the increase took place in the beginning of this year; U.S. housing starts have actually been falling slowly since the



first quarter of 2002. The outlook calls for further softening, with housing starts falling below 1.6 million units for the first time since 2000 in 2003. This forecast reflects the influence of several factors. First, with mortgage interest rates already at record lows, and the Federal Reserve's determination to sit tight on the federal funds rate, it is highly unlikely that mortgage interest rates will drift further south. This should gradually erode the affordability of purchasing a home. Second, banks also appear to be tightening their lending standards in response to an increasing amount of home loans that have soured. Third, housing prices should be coming under some downward pressure, making it a less attractive investment option. Despite these factors, the housing sector is not expected to tank. First, the decreases are projected to be gradual and from very high levels of activity. Second, the anticipated improvement in employment should offset some of the negative factors. Third, real estate markets tend to be regional, so any price drops would be locally contained.

**U.S. Imports and Exports**

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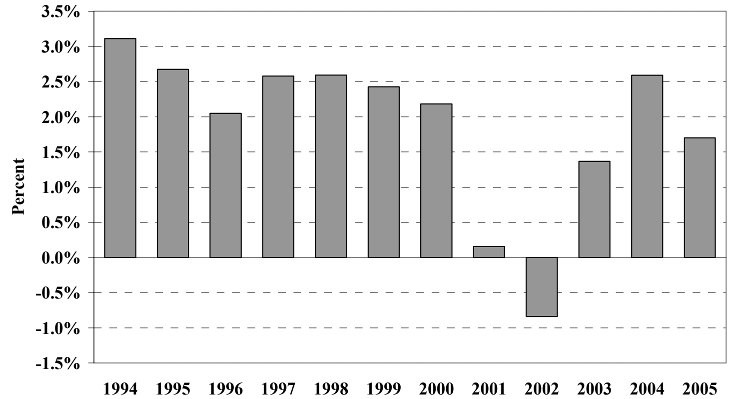
**International:** The outlook for one of the world's economic brighter spots, Europe, has dimmed. The anticipated softer performance for this region is based on the well documented slowing of its fragile recovery. According to the September 2002 Purchasing Managers' Survey, activity in the dominant services sector contracted for the first time since December 2001. The survey also reported services employment declined at is fastest rate since the survey began in mid-1998. European manufacturing activity declined in September, which was its first retreat since February 2002. In September, output and new orders both declined for the first time since the beginning of the year. Meanwhile, overall economic sentiment in Europe fell back for the third successive month in August, to reach an eight-month low, before edging up in September. Another view of the data show both European businesses and consumers have experienced jitters recently. Business confidence in September remained at its lowest level since February in September. Consumer confidence has remained fairly subdued all year. Leading indicators for the region also make for depressing reading. In particular, the OECD composite leading indicator fell for the third month running in August. On the other hand, Japan's economy showed signs of life during the first half of this year. However, the world's second largest economy is not expected to become a major engine of economic growth until it solves its structural inefficiencies. For example, there is excess employment in construction. Lenient creditors allow bankrupt firms to operate, which keeps excess capacity high and exacerbates deflation. Given the forecast for a sluggish world economic recovery, it is no surprise the United State's real trade deficit is expected to swell from $473.3 billion in 2002 to $530.6 billion in 2005.

**Employment:** Recent improvements in the labor sector do not mean employment has yet turned the corner. In August 2002, the U.S. civilian unemployment rate dropped to 5.7% from the previous month's 5.9%. However, this drop is suspicious in light of other labor statistics. For example, during the summer the economy has a net payroll gain of about 40,000 jobs per month. While this growth is welcomed, it falls far short of the estimated 120,000 jobs it would take just to absorbed new labor-force entrants. As such, it is believed that the U.S. civilian unemployment rate will not peak until early 2003. This forecast reflects the soft outlooks for several key sectors. Manufacturing continues to shed jobs. Recently, manufacturing payrolls have shrunk an average of 30,000 per month. In a more typical expansion, manufacturing employment would be flat, but not declining. The falling manufacturing employment helps account for this sector's impressive productivity gains. Construction employment has also been disappointing. The culprit here is business construction, which is expected to trail the overall recovery with a large lag. State and local government building should also be suppressed by strapped budgets. Given the prospects for manufacturing and construction, most of the employment growth is expected to come from services. This sector has already gotten a lift from the economic turnaround, but so far these gains have been largely offset by declines in key sectors that are restructuring. The unwinding of the "new economy" labor excesses reaches beyond the dot-com bust. Perhaps the most publicized is the unfolding of telecom services. In addition, the entire financial sector has had stable employment, but could begin shedding jobs down the road because of over capacity. It has been estimated that at least half of investment banking employment may have been tied to services that cannot be sold in the current business environment. The transportation sector is still dealing with the slow economy and the fallout from September 11, 2001. State and local governments will provide limited job opportunities as they grapple with huge budget imbalances. Not all the government employment news is bad, however. Federal civilian and military payrolls have done well, thanks to increased spending for homeland security and national defense. Another positive sign is the steady growth in health-care employment. In summary, U.S. employment is about six months away from a steady, but gradual, recovery. The national civilian unemployment rate is anticipated to peak at 6.2% in the first quarter of next year, and then gradually approach the full-employment rate of 5.0% by 2005. After declining 0.8% this year, payroll employment is expected to increase 1.4% next year, 2.6% in 2004, and 1.7% in 2005.

**U.S. Nonfarm Employment Growth**

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